TENNESSEE DEPARTMENT OF REVENUE
REVENUE RULING # 07-14

WARNING

Revenue rulings are not binding on the Department. This presentation of the ruling in a redacted form is information only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Departmental policy.

SUBJECT

The use by a parent corporation of a subsidiary corporation's net operating loss carryforward, where the subsidiary has either dissolved, merged into the parent, converted to a single member limited liability company, or undergone a reorganization pursuant to 26 U.S.C. § 368(a)(1)(F).

SCOPE

Revenue Rulings are statements regarding the substantive application of law and statements of procedure that affect the rights and duties of taxpayers and other members of the public. Revenue Rulings are advisory in nature and are not binding on the Department.

FACTS

The Taxpayer is the ultimate parent corporation in a large affiliated group, which files a consolidated federal income tax return. The Taxpayer is incorporated and commercially domiciled outside of Tennessee. However, the Taxpayer is subject to tax within Tennessee, and has filed Tennessee tax franchise and excise tax returns.

Over the last several years, the Taxpayer has streamlined its operations through transactions involving third parties, as well as internal restructurings that eliminated affiliates no longer deemed necessary to the organization. Elimination of entities pursuant to the internal restructuring was accomplished through (1) dissolution of the affiliate, (2) merger of the affiliate into the Taxpayer or (3) conversion of the affiliate from a corporation to a disregarded single member limited liability company wholly owned by the Taxpayer ("SMLLC"). The Taxpayer has also suggested that certain affiliates may undergo a tax-free reorganization pursuant to 26 U.S.C. § 368(a)(1)(F) (an "F reorganization"). Certain of these affiliates had unused Tennessee net operating loss ("NOL") carryforwards.

QUESTIONS

1. Is the Taxpayer entitled to use a Tennessee NOL carryforward generated by an affiliate that has (1) dissolved, (2) merged into the Taxpayer, (3) converted to a disregarded SMLLC wholly-owned by the Taxpayer, or (4) undergone an F reorganization?

2. Does the result in Question #1 change if the Taxpayer and its affiliate are both financial institutions?

3. Does the result in Question #1 change if the Taxpayer is a financial institution, but the affiliate is not?

4. Does the result in Question #1 change if the Taxpayer is not a financial institution, but the affiliate is?

5. Do the results in Questions #1-#4 change based on whether the affiliate was legally dissolved, merged out of existence or converted?

6. If the affiliate originally filed Tennessee franchise and excise tax returns as a corporation and subsequently began to file as a financial institution before the dissolution, merger or conversion, will the affiliate's NOL carryforward that was generated when it was filing as a corporation succeed to the Taxpayer upon the affiliate's dissolution, merger or conversion?

RULINGS

1. *No*. The Taxpayer may not use the NOL carryforward of an affiliate that has (1) dissolved; (2) merged out of existence and into the Taxpayer; (3) converted from a corporation to a SMLLC wholly owned by the Taxpayer; or (4) been a party to an F reorganization.

2. *No*. The result in Question #1 does not change if the Taxpayer and its affiliate are members of one financial institution unitary group. However, the Taxpayer's financial institution unitary group may use the NOL carryforward generated by a group member that has been a party to an F reorganization, provided that the affiliate is in existence as a member of the unitary group at the end of the unitary group's tax year.

3. *No*. The result in Question #1 does not change if the Taxpayer is a financial institution, but the affiliate is not.

4. *No*. The result in Question #1 does not change if the affiliate is a financial institution, but the Taxpayer is not.

5. *No*. The results in Questions #1-#4 do not change based on whether the affiliate was legally dissolved, merged out of existence or converted.

6. *No*. The Taxpayer is not entitled to use the NOL carryforward generated by its affiliate.

ANALYSIS

Tennessee imposes an excise tax at the rate of 6.5 percent on the "net earnings" of certain persons doing business within Tennessee. Tenn. Code Ann. § 67-4-2007(a). Persons subject to the excise tax include, but are not limited to, corporations and limited liability companies. Tenn. Code Ann. § 67-4-2004(29). Tenn. Code Ann. § 67-4-2006(a)(1) defines "net earnings" or "net loss" of a corporation as "federal taxable income or loss before the operating loss deduction and special deductions provided for in 26 U.S.C. §§ 241-247 and 249, and as adjusted by subsections (b) and (c) of this section."

Tenn. Code Ann. § 67-4-2006(c)(1) permits a taxpayer to deduct a net operating loss from its net earnings in the computation of its Tennessee excise tax liability; qualified net operating losses may be carried forwarded and deducted for up to fifteen years.

Tenn. Code Ann. § 67-4-2006(c)(2) provides that, except for unitary groups of financial institutions, each taxpayer is considered a separate entity. In the case of mergers, consolidations, and like transactions, no loss carryforwards incurred "by the predecessor taxpayer are allowed as a deduction from net earnings on the excise tax return filed by the successor taxpayer." *See AT & T Corporation v. Johnson*, 148 S.W.3d 74 (Tenn.Ct.App. 2004) (holding that taxpayer was not entitled to use of net operating loss incurred by predecessor); *Little Six Corporation v. Johnson*, 1999 WL 336308 (Tenn.Ct.App. No. 01-A-01-9806-CH00285, May 28, 1999) (holding that taxpayer was not entitled under TENN. COMP. R. & REGS. § 1320-6-1-.21(2)(d) to use of net operating loss incurred by predecessor). *Id*. Tenn. Code Ann. § 67-4-2006(c)(2) further provides that "a loss carryforward may be taken only by the taxpayer that generated it, with the exception set forth in Tenn. Code Ann. § 67-4-2006(c)(3)." *Id*. Tenn. Code Ann. § 67-4-2006(c)(3) provides that when a taxpayer merges out of existence and into a successor taxpayer that has "no income, expenses, assets, liabilities, equity or net worth," any qualified Tennessee loss carryover of the predecessor that merged out of existence shall be available for carryforward and deduction from the net earnings of the surviving successor.

Tenn. Code Ann. § 67-4-2006(c)(4) provides that a unitary group of financial institutions may take "any qualified loss carryforward that was generated by any group member that is in existence as a member of the group at the end of the group's tax year; provided, that such loss carryover has not previously been taken by the member itself before it joined the group or by another unitary group of financial institutions at the time the financial institution generating the loss was a member of that group; and provided, that the loss carryover shall be subject to the limitations" set forth in the provisions relating to loss carryforwards.

1. <u>Use of the affiliate's NOL carryforward if neither the Taxpayer nor the affiliate are members of a financial institution unitary group.</u>

For purposes of the Tennessee excise tax, the Taxpayer may not use the NOL carryforward of an affiliate that has (1) dissolved; (2) merged out of existence and into the Taxpayer; (3) converted from a corporation to a SMLLC wholly owned by the Taxpayer; or (4) been a party to an F reorganization. It is assumed for purposes of this question that neither the Taxpayer nor the affiliate are members of a financial institution unitary group.

As noted above, Tenn. Code Ann. § 67-4-2006(c)(1) permits a taxpayer to deduct a net operating loss from its net earnings in the computation of its Tennessee excise tax liability; qualified net operating losses may be carried forwarded and deducted for up to fifteen years. Tenn. Code Ann. § 67-4-2006(c)(2) provides that, except for unitary groups of financial institutions, each taxpayer is considered a separate entity. In the case of mergers, consolidations, and like transactions, no loss carryforwards incurred "by the predecessor taxpayer are allowed as a deduction from net earnings on the excise tax return filed by the successor taxpayer." *Id*. Tenn. Code Ann. § 67-4-2006(c)(2) further provides that "a loss carryforward may be taken only by the taxpayer that generated it, with the exception set forth in Tenn. Code Ann. § 67-4-2006(c)(3)." *Id*. Tenn. Code Ann. § 67-4-2006(c)(3) provides that when a taxpayer merges out of existence and into a

successor taxpayer that has "no income, expenses, assets, liabilities, equity or net worth," any qualified Tennessee loss carryover of the predecessor that merged out of existence shall be available for carryforward and deduction from the net earnings of the surviving successor.

1) Dissolution of affiliate. In the event an affiliate makes a liquidating distribution of its assets to the Taxpayer and subsequently dissolves, the affiliate's NOL does not survive the dissolution and the Taxpayer does not succeed to the affiliate's NOL. As noted above, Tenn. Code Ann. § 67-4-2006(c)(2) provides that a loss carryforward may be taken only by the taxpayer that generated it, unless the taxpayer merges out of existence and into a successor taxpayer that has "no income, expenses, assets, liabilities, equity or net worth." In this case, the affiliate has not merged into another entity; rather, it has liquidated its assets and dissolved. Accordingly, the Taxpayer may not use the dissolved affiliate's NOL carryforward.

2) Merger of affiliate into Taxpayer. In the event an affiliate merges out of existence and into the Taxpayer, the Taxpayer does not succeed to the affiliate's NOL. Pursuant to Tenn. Code Ann. §§ 67-4-2006(c)(2) and 67-4-2006(c)(3), the affiliate's NOL carryforward will not be allowed as a deduction from the net earnings of the Taxpayer unless the Taxpayer is a successor taxpayer that has no income, expenses, assets, liabilities, equity or net worth. The facts presented indicate that the Taxpayer has income, expenses, assets, liabilities, equity and/or net worth. Accordingly, the Taxpayer is not the type of successor taxpayer that may succeed to the NOL of the merged affiliate. The NOL of the affiliate will therefore not be available for carryforward and deduction from the net earnings of the Taxpayer.

3) Conversion of affiliate to a SMLLC under state law. In the event an affiliate converts under state law from a corporation to a SMLLC wholly owned by the Taxpayer, the Taxpayer does not succeed to the affiliate's NOL.

A SMLLC that is wholly owned by a corporation and that is disregarded for federal income tax purposes will be disregarded for Tennessee franchise and excise tax purposes as well.[1] The disregarded SMLLC is treated as a division of its parent corporation. Thus, when a subsidiary corporation converts to a SMLLC under state law, the subsidiary becomes a division of the parent corporation for Tennessee franchise and excise tax purposes.

Such a conversion is tantamount to a merger of the subsidiary corporation out of existence and into the parent corporation. Accordingly, the conversion of the affiliate corporation to a SMLLC wholly owned by the Taxpayer is considered for Tennessee excise tax purposes to be a merger of the affiliate out of existence and into the Taxpayer, with the Taxpayer as the successor entity. Pursuant to Tenn. Code Ann. §§ 67-4-2006(c)(2) and 67-4-2006(c)(3), the affiliate's NOL carryforward will not be allowed as a deduction from the net earnings of the Taxpayer unless the Taxpayer is a successor entity that has no income, expenses, assets, liabilities, equity or net worth. As noted above, the facts presented indicate that the Taxpayer has income, expenses,

[1] Tenn. Code Ann. §§ 67-4-2007(d) and 67-4-2106(c) provide that, for purposes of Tennessee franchise and excise taxation, a business entity shall be classified as a corporation, partnership, or other type of business entity, consistent with the way the entity is classified for federal income tax purposes. Tenn. Code Ann. §§ 67-4-2007(d) and 67-4-2106(c) further provide that "entities that are disregarded for federal income tax purposes, except for limited liability companies whose single member is a corporation, shall not be disregarded" for Tennessee franchise and excise tax purposes.

assets, liabilities, equity and/or net worth. Accordingly, the Taxpayer is not the type of successor taxpayer that may succeed to the NOL of the merged affiliate. The NOL of the affiliate will therefore not be available for carryforward and deduction from the net earnings of the Taxpayer.

4) F reorganization of affiliate. The Taxpayer has suggested that the Taxpayer would succeed to the affiliate's NOLs if the affiliate is a party to an F reorganization. The Taxpayer, however, would not succeed to the affiliate's NOL in the event the affiliate were a party to an F reorganization. 26 U.S.C. § 368(a)(1)(F) provides that the term "reorganization" includes "a mere change in identity, form, or place of organization of one corporation, however effected." [Emphasis added.] Importantly, an F reorganization cannot involve the merger or consolidation of two separate operating companies.[2] Because the affiliate and the Taxpayer are both operating companies, the merger of the two would not qualify as an F reorganization. As discussed above, the Taxpayer would be unable to use the affiliate's NOL after a merger of the affiliate into the Taxpayer, because the Taxpayer would not be a successor entity that has no income, expenses, assets, liabilities, equity or net worth. Note that an affiliate that has undergone an F reorganization by merging out of existence and into a shell corporation would likely be able to use NOLs generated before the reorganization.

2. Use of the affiliate's NOL carryforward if both the Taxpayer and the affiliate are members of one financial institution unitary group.

For purposes of the Tennessee excise tax, the Taxpayer's financial institution unitary group[3] may not use the NOL carryforward generated by a group member that has (1) dissolved; (2) merged out of existence and into the Taxpayer; or (3) converted from a corporation to a SMLLC wholly owned by the Taxpayer. However, the Taxpayer's financial institution unitary group may use the NOL carryforward generated by a group member that has been a party to an F reorganization, provided that the affiliate is in existence as a member of the unitary group at the end of the unitary group's tax year.

Tenn. Code Ann. § 67-4-2006(c)(1) permits a taxpayer to deduct a net operating loss from its net earnings in the computation of its Tennessee excise tax liability; qualified net operating losses may be carried forwarded and deducted for up to fifteen years. Tenn. Code Ann. § 67-4-2006(c)(4) provides that a unitary group of financial institutions may take "any qualified loss carryforward that was generated by any group member that is in existence as a member of the group at the end of the group's tax year; provided, that such loss carryover has not previously been taken by the member itself before it joined the group or by another unitary group of

[2] Note that an F reorganization may involve two corporations under certain circumstances, such as the reincorporation of the operating company in another state. Importantly, however, such F reorganizations are accomplished through the use of a single operating company and a shell corporation. *See* H.R. Rep. No. 760, 97th Cong., 2d Session (1982). For example, suppose that Corporation X wishes to reincorporate in another state. A shell corporation, Y, is formed in the new state. Corporation X then merges into Corporation Y, with Corporation Y as the surviving entity.

[3] Tenn. Code Ann. § 67-4-2007(e)(2) provides that unitary groups of financial institutions must file a combined Tennessee franchise and excise tax return and pay tax based on the apportioned combined net earnings of the entire unitary group. One taxpayer must be designated to file the return. It is assumed for purposes of this ruling that, as the parent corporation, the Taxpayer would be the entity that files the combined return on behalf of the unitary group.

financial institutions at the time the financial institution generating the loss was a member of that group; and provided, that the loss carryover shall be subject to the limitations" set forth in the provisions relating to net operating loss carryforwards.

1) Dissolution of affiliate. In the event an affiliate that is a member of the Taxpayer's financial institution unitary group makes a liquidating distribution of its assets to the Taxpayer and subsequently dissolves, the unitary group cannot use the NOL carryforward generated by the affiliate. As noted above, Tenn. Code Ann. § 67-4-2006(c)(4) provides that the unitary group may take any NOL carryforward "that was generated by any group member that is in existence as a member of the group at the end of the group's tax year." By virtue of having dissolved, the affiliate is not in existence as a member of the group at the end of the group's tax year. Accordingly, the NOL carryforward generated by the affiliate is not available for use by the unitary group.

2) Merger of affiliate into Taxpayer. In the event an affiliate that is a member of the Taxpayer's financial institution unitary group merges out of existence and into the Taxpayer, the unitary group cannot use the NOL carryforward generated by the affiliate. As noted above, Tenn. Code Ann. § 67-4-2006(c)(4) provides that the unitary group may take any NOL carryforward "that was generated by any group member that is in existence as a member of the group at the end of the group's tax year." By virtue of having merged out of existence and into the Taxpayer, the affiliate is not in existence as a member of the group at the end of the group's tax year. Accordingly, the NOL carryforward generated by the affiliate is not available for use by the unitary group.

3) Conversion of affiliate to a SMLLC under state law. In the event an affiliate that is a member of the Taxpayer's financial institution unitary group converts under state law from a corporation to a disregarded SMLLC wholly owned by the Taxpayer, the unitary group cannot use the NOL carryforward generated by the affiliate. As discussed in the analysis of Question #1, a disregarded SMLLC is treated as a division of its parent corporation for Tennessee franchise and excise tax purposes. Upon converting to a SMLLC, the subsidiary corporation becomes a division of the parent corporation. Such a conversion is tantamount to a merger of the subsidiary corporation out of existence and into the parent corporation. Accordingly, the conversion of the affiliate corporation to a disregarded SMLLC wholly owned by the Taxpayer is considered for Tennessee excise tax purposes to be a merger of the affiliate out of existence and into the Taxpayer. As noted above, Tenn. Code Ann. § 67-4-2006(c)(4) provides that the unitary group may take any NOL carryforward "that was generated by any group member that is in existence as a member of the group at the end of the group's tax year." By virtue of having merged out of existence, the affiliate is not in existence as a member of the group at the end of the group's tax year. Accordingly, the NOL carryforward generated by the affiliate is not available for use by the unitary group.

4) F reorganization of affiliate. In the event that an affiliate that is a member of the Taxpayer's financial institution unitary group undergoes an F reorganization, the unitary group may continue to use the NOL carryforward generated by the affiliate, provided that the affiliate is in existence as a member of the unitary group at the end of the unitary group's tax year.

3. Use of the affiliate's NOL carryforward if the Taxpayer is a financial institution and the affiliate is not.

The Taxpayer has asked whether the response to Question #1 would change if the Taxpayer were a financial institution and the affiliate were not. The response to Question #1 would not change under these facts.

Tenn. Code Ann. § 67-4-2007(e)(1) provides that, except for unitary groups of financial institutions and business entities that have been required or permitted to file excise tax returns on a combined, consolidated or separate accounting basis, each taxpayer is considered a separate and single business entity for Tennessee excise tax purposes. Thus, if the affiliate is not a financial institution, it will be considered a single business entity separate from the Taxpayer (and the Taxpayer's financial institution unitary group, if one exists). The analysis under Question #1 therefore applies.

4. Use of the affiliate's NOL carryforward if the affiliate is a financial institution and the Taxpayer is not.

The Taxpayer has asked whether the response to Question #1 would change if the affiliate were a financial institution and the Taxpayer were not. The response to Question #1 would not change under these facts.

Tenn. Code Ann. § 67-4-2007(e)(1) provides that, except for unitary groups of financial institutions and business entities that have been required or permitted to file excise tax returns on a combined, consolidated or separate accounting basis, each taxpayer is considered a separate and single business entity for Tennessee excise tax purposes. Thus, if the Taxpayer is not a financial institution, it will be considered a single business entity separate from the affiliate (and the affiliate's financial institution unitary group, if one exists). The analysis under Question #1 therefore applies.

5. Change of results in Questions #1-#4.

The Taxpayer has asked whether the results in Questions #1-#4 would change based on whether the affiliate was legally dissolved, merged out of existence or converted to a SMLLC. The analysis of Questions #1-#2 discusses each of these scenarios in detail.

6. Use of the affiliate's NOL carryforward if the affiliate generated the NOL before becoming a financial institution, and the affiliate dissolves, merges or converts to an SMLLC.

The Taxpayer has asked whether the NOL carryforward would be available to the Taxpayer if the affiliate incurred the NOL before becoming a financial institution, and the affiliate dissolves, merges or converts to an SMLLC after becoming a financial institution.

The Taxpayer would not succeed to the NOL carryover of the affiliate under this scenario. If the Taxpayer is not a financial institution, the analysis provided under Question #1 applies. If the Taxpayer is a member of a financial institution unitary group, and the affiliate was a member of

that group before its dissolution, merger or conversion, the analysis provided under Question #2 applies.

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